

RATIO ANALYSIS

Ratios:

1. Solvency Ratios:

Working Capital	=	Current Assets – Current Liabilities
Current Ratio	=	CA / CL (Ideal 2)
Acid Test Ratio	=	$\frac{CA - \text{Stock}}{CL}$ (Ideal 1)

2. Activity Ratio:

Period of Credit allowed:	$\frac{\text{Debtors}}{\text{Sales}}$	X	365	(Answer in days)
Period of Credit taken:	$\frac{\text{Creditors}}{\text{Purchases}}$	X	365	(Answer in days)
Stock Turnover:	$\frac{\text{Cost of Sales}}{\text{Closing Stock}}$	=	No. times stock has turned over	

3. Profitability Ratios:

Gross Margin:	$\frac{\text{Gross Profit}}{\text{Sales}}$	X	100	
Net Margin:	$\frac{\text{Net Profit}}{\text{Sales}}$	X	100	
Average Monthly Overhead	Total overheads / 12			

Profit & Loss Account:

	2011	2010
Sales	140,000	100,000
Cost of Sales	<u>90,000</u>	<u>60,000</u>
Gross Profit	50,000	40,000
Overheads	<u>51,000</u>	<u>32,000</u>
Net Profit	<u>(1,000)</u>	<u>8,000</u>

Balance Sheet:

	2011	2010		2011	2010
Share Capital	20,000	20,000	Fixed Assets	80,000	70,000
Balance on P&L a/c	24,000	25,000	Current Assets:		
Term Loans	56,000	40,000	-- Stocks	8,000	7,000
Current Liabilities:			-- Debtors	24,000	11,000
-- Bank Overdraft	4,000		-- Bank	<u>--</u>	<u>2,000</u>
-- Creditors	<u>8,000</u>	<u>5,000</u>			
	<u>112,000</u>	<u>90,000</u>		<u>112,000</u>	<u>90,000</u>

Compute:

Gross Margin
 Net Margin
 Debtors Days
 Creditors Days
 Stock Turnover
 Working Capital
 Current Ratio
 Acid Test Ratio

RATIO ANALYSIS – ITS LIMITATIONS

A ratio is simply one item expressed in terms of another. The limitations of ratio analysis are:

- a. Only when related to other pertinent information is ratio analysis of any significance.
- b. A ratio is only significant when compared with an agreed standard.
- c. A ratio is useful when a significant relationship exists between the figures forming the ratio.
- d. Ratios are only used as a guide and thus should only be used in conjunction with other data.

Comparisons of ratios from period to period can indicate if business policy is achieving the overall objective of the business. The overall objective is a satisfactory return on capital employed while maintaining a strong financial position.

In general, ratios are useful when:

- a. Compared with previous years to show if any bad trends are developing.
E.g. too much money tied up in stock.
- b. Compared with other firms in the industry.
- c. You wish to see if the ratios compared with the industry average.

THE NEED FOR PERIODIC STATEMENTS

Periodic statements summarise transactions of past period, and in such a way provide useful information.

The profit statement seeks to inform:

- The shareholders / investors on profitability and solvency
- The lenders on interest cover and repayment capacity

The investors / owners of the business have invested their money in order to earn a return on funds invested and to see the value of their investment grow.

Financial Institutions lend money in order to gain interest earnings and expect to be fully repaid at the end of the term of the loan.

So what information do these investors and lenders need? They need information to answer the following:

1. Is the business financially sound?
2. Will the business make a profit?
3. Will the business increase in value?
4. Can the business pay its debts?
5. How well is the money advanced being used?

Financial statements are prepared to provide answers to these questions. The profit statement reflects management performance in the operations of the business. The balance sheet shows the financial position of the company at the end of the trading period. A ratio analysis of these statements is also an aid in satisfying the information needs of these lenders and investors.

Who uses these periodic statements?

1. People involved with the business

- 1) The business owners,
who want to know if the business is profitable/ increasing in value.
- 2) The business managers,
who want to know if they are using the resources of the business efficiently and successfully.

2. People not involved with the business

- 1) Bankers and lenders: interested in securing interest on the loan
- 2) Revenue commission: interested in assessing tax liability
- 3) Competition Authority.
- 4) Trade Unions: is the wage bill acceptable?
- 5) Suppliers: especially of goods on credit
- 6) Financial Commentators in the press to assist in the comparison of businesses
- 7) Investors:
- 8) Trade Associations: interested in generating statistics in particular areas of industry.